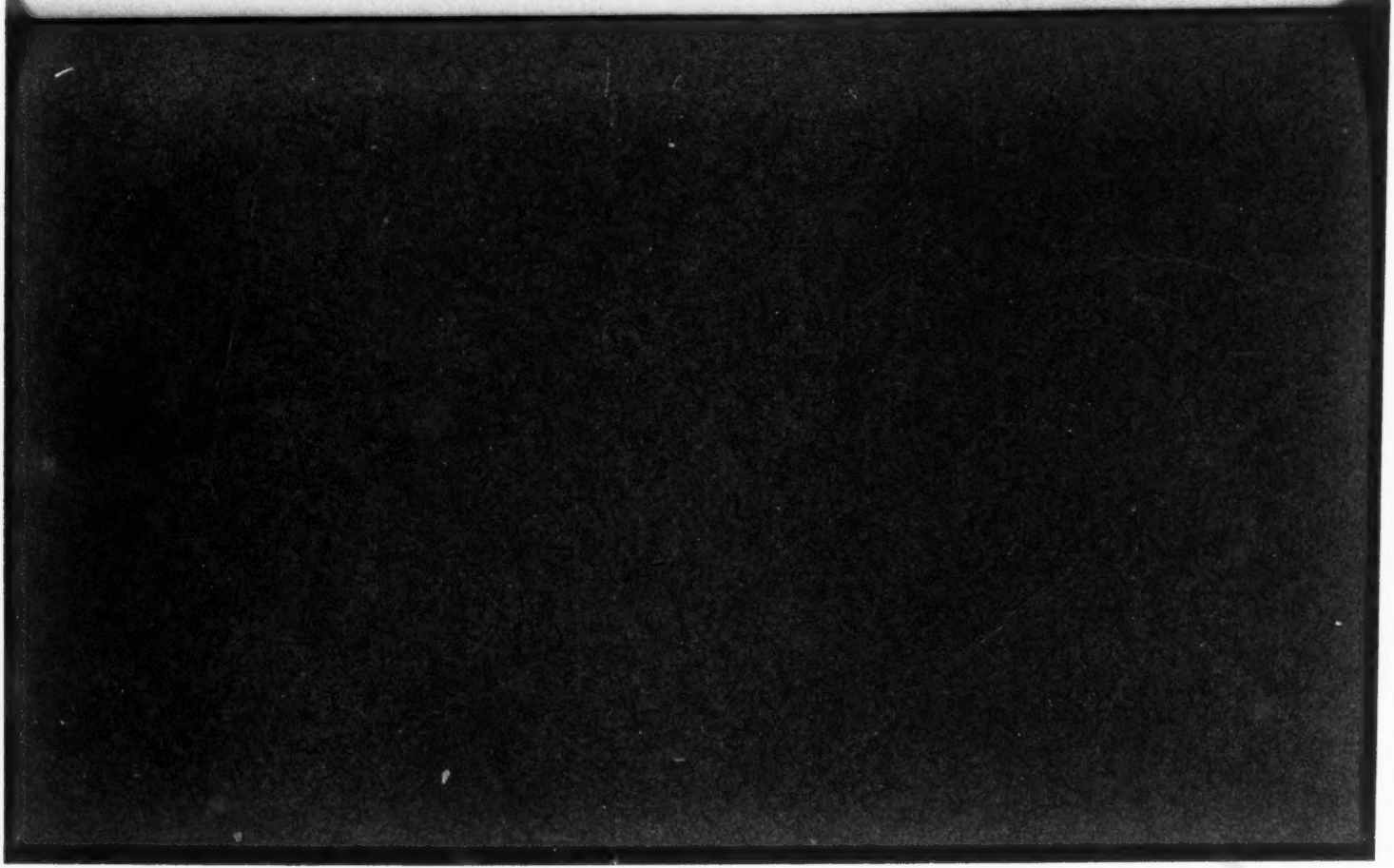

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	2
Argument	4
Conclusion	9
Appendix	10

CITATIONS

Cases:	
Commissioner v. *James*, 49 F. 2d 707	5
Detroit & Windsor Ferry Co. v. *Woodworth*, 115 F. 2d 795, certiorari denied, 312 U. S. 692	9
Fawcus Machine Co. v. *United States*, 282 U. S. 375	8
Hadden v. *Commissioner*, 49 F. 2d 709	4, 5
Nichols, J. C., Land Co. v. *Commissioner*, 65 F. 2d 437	9
Niles Bement Pond Co. v. *United States*, 281 U. S. 357	7
United States v. *Mitchell*, 271 U. S. 9	7
Utah Power & Light Co. v. *Commissioner*, 243 U. S. 389	9
Statutes:	
Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 31	4, 5
Revenue Act of 1917, c. 63, 40 Stat. 300, Sec. 1211	4
Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 201	6
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 41	10
Sec. 43	10
Sec. 115	5, 10
Miscellaneous:	
G. C. M. 2951, VII–1, Cum. Bull. 160 (1928)	8
I. T. 3253, 1939–1 Cum. Bull. 178	8
T. D. 5059, 1941–2 Cum. Bull. 125	8
Treasury Regulations 62, Art. 1542	8
Treasury Regulations 45, Art. 1542	8
Treasury Regulations 94:	
Art. 41–1	11
Art. 41–2	12
Art. 43–1	12
Art. 115–1	13
Art. 115–2	14
Art. 115–3	14

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 416

M. H. ALWORTH TRUST, M. W. ALWORTH AND R. D. ALWORTH, TRUSTEES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 9–14) is reported at 46 B. T. A. 1045. The opinion of the Circuit Court of Appeals (R. 24–28) is reported at 136 F. 2d 812.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 12, 1943 (R. 29). Petition for a writ of certiorari was filed October 8, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code (28 U. S. C. 1940 ed., Sec 347), as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In determining the earnings or profits of a corporation available for dividends under Section 115 (a) of the Revenue Act of 1936, where it is on the cash basis, should there be deducted the income and excess profits taxes paid during the year, as held by the court below, or those accruing during the year but not paid until the following year, as contended by the taxpayer?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra,* pp. 10–15.

STATEMENT

The facts are not in dispute and are as follows:

Petitioners are the trustees of a testamentary trust created under the will of M. H. Alworth, deceased. During the year 1937 they were the owners of three-tenths of the outstanding stock of the Royal Mineral Association, a Minnesota corporation, which stock had passed to them under the decedent's will. (R. 10.)

The Royal Mineral Association was organized about 1909 and throughout its existence owned certain mineral interests on Mesaba Range in Minnesota. It was liquidated and dissolved toward the end of 1939. In each year of its existence it distributed to its stockholders all of its net earnings for the year and substantial amounts from depletion reserves. As a consequence it never, from one year to the next, had an earned surplus. In 1917 and each year thereafter the net income of the corporation, less the federal income

and excess profits taxes accruing for such year, was regarded as the portion of the distribution which constituted dividends, the remainder being regarded as a distribution of capital (i. e., as a distribution out of depletion reserves). (R. 10.)

The corporation's taxable net income for 1937 was $464,033.94 on which the federal income tax was $92,552.88, all paid in 1938. During 1937 the Association paid federal income tax in the amount of $30,606.76 on its income for 1936. In computing the amount of the corporation's 1937 earnings or profits available for distribution, the corporation and the petitioners, in accordance with their prior practice, deducted from the corporation's taxable net income of $464,033.94 the $92,552.88 of income tax payable thereon and arrived at $371,481.06 as the amount available for such distribution. In determining the deficiency due from the petitioners, as trustees, the Commissioner deducted from the corporation's net income of $464,033.94 the amount of $30,606.76 representing the income tax which the corporation paid during 1937 on 1936 income, and thereby determined that $433,427.18 was available for distribution as dividends. (R. 10.)

During 1937 the trustees received distributions in the sum of $218,070 from the Royal Mineral Association. Under the method which they used in computing the amount of earnings or profits of the Association available for dividends, the trustees ascertained that $111,444.24 of the $218,070 they had received constituted taxable dividends and accordingly the trustees reported the $111,444.24 as taxable dividends in

the income tax return of the trust for 1937. Under the method which he used, the Commissioner determined that $130,028.60 of the $218,070 constituted taxable dividends and increased the amount which the trustees had received from that source by $18,584.36. (R. 10–11.)

The Royal Mineral Association always filed its income tax returns on the cash receipts and disbursements basis (R. 11).

The Board of Tax Appeals sustained the contention of the petitioners (R. 9–14). The Circuit Court of Appeals reversed the Board of Tax Appeals and affirmed the determination of the Commissioner (R. 23–28).

ARGUMENT

The decision below is correct and presents no conflict. There is no occasion for further review.

Superficially there may appear to be a conflict between the decision below and *Hadden* v. *Commissioner,* 49 F. 2d 709 (C. C. A. 2d), but actually there is none due to the essential difference between the statutes respectively involved. The statute in the *Hadden* case (Section 31 (a), Revenue Act of 1916, c. 463, 39 Stat. 756, as added by Section 1211 of the Revenue Act of October 3, 1917, c. 63, 40 Stat. 300) reads as follows:

> SEC. 31. (a) That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits *accrued since* March first, nineteen hun-

> dred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of the earnings or profits so distributed. [Italics ours.]

Thus the statute involved in the *Hadden* case specified accrued earnings or profits, i. e., "earnings or profits accrued since" March 1, 1913. A dividend from "earnings or profits accrued" after the critical date was subjected to tax. It was, accordingly, arguable that under such a statute the corporation would not have "earnings or profits accrued" unless its accrued taxes were taken into account. Moreover, under the Act of 1916 it was necessary to determine the earnings of the corporation for the portion of the taxable year to the date of distribution, and the Commissioner's defense was concentrated upon the sole issue that the taxes were unknown at the distribution date and would not accrue until the end of the year. As a result the court had no occasion to consider whether a different rule should be applied where the corporation was on the cash basis.[1]

The term "dividend" is used in the Revenue Act of 1936 (Section 115, Appendix, *infra*) in a less restricted sense. It is defined there as meaning any corporate

[1] The corporation whose dividends were under consideration in *Commissioner* v. *James*, 49 F. 2d 707 (C. C. A. 2d), kept its books and made its returns upon the accrual basis. Thus obviously its "earnings or profits" had to be determined by the accrual method. The court said (p. 708): "The tax does not stand on any different footing from other accrued expenses appearing on the * * * [corporation's] books."

distribution (1) out of earnings or profits *accumulated*[2] after February 28, 1913, or, (2) out of earnings or profits for the taxable year. Such a provision in no way implies that earnings and profits shall be determined upon the accrual basis rather than upon the cash basis where the latter is the corporation's method of keeping its accounts and making its income tax returns.

The corporation whose earnings and profits are involved here always filed its income tax returns on the cash receipts and disbursements basis (R. 11) and there is no question that it was on that basis of accounting. The suggestion of the petitioners (Br. 21) that every person has the right to select his own method of computing the amount of earnings and profits *of corporations* in which he is a stockholder, is not worthy of serious consideration.

The decision below preserves the well established distinction between the cash and the accrual methods of corporate accounting. Petitioners on the other hand, in ultimate analysis, contend that all items of gross income, and all deduction items *but one,* which enter into the determination of the "earnings or profits" of the Royal Mineral Association for the tax year, should be determined upon the cash basis. Thus they contend for the determination of corporate "earn-

[2] All Revenue Acts since 1916 have used the term "accumulated" instead of "accrued." See, for example, Section 201 of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

ings or profits" upon a hybrid basis, predominantly cash but as to one item, accrual.[3]

The decision below accords with the decision of this Court in *United States* v. *Mitchell,* 271 U. S. 9. There the Court held that where the accounts of an estate were kept on the basis of actual receipts and disbursements the executors could not deduct from the income of the taxable year the estate tax which had accrued during the year but was not paid until later. In so holding the Court said (pp. 12–13):

> Assuming, as we must, that the accounts of the estate were kept on the basis of actual receipts and disbursements, the executors were required to make return on that basis. Notwithstanding the option given taxpayers, it is the purpose of the Act to require returns that clearly reflect taxable income. That purpose will not be accomplished unless income received and deductible disbursements made are treated consistently. It was not the purpose of the Act to permit gross income actually received to be diminished by taxes or other deductible items disbursed

[3] If the one departure from the cash basis be permitted the exception conceivably may destroy the general rule, with the result that all other accrued liabilities and all accrued income items would have to be taken into account in determining the "earnings or profits" of a *cash basis* corporation. Cf. *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, where the corporation was on the accrual basis and this Court held (p. 360) that the corporate deduction for foreign taxes must be "accrued so as to reflect true income by conforming to the *dominating or controlling character of the taxpayer's system of accounts.*" [Italics ours.]

> in a later year, even if accrued in the taxable year. It is a reasonable construction of the law that the same method be applied to both sides of the account.

There is no conflict with *Fawcus Machine Co.* v. *United States,* 282 U. S. 375, for the question there concerned invested capital and in any event the corporation was on the accrual basis. Nor do the regulations which the Commissioner issued even under the earliest acts support the petitioners' argument. True, Article 1542 of Treasury Regulations 62, promulgated under the Revenue Act of 1921, reads in part as quoted in petitioners' brief (p. 12). Compare Article 1542, Treasury Regulations 45, promulgated under the Revenue Act of 1918. But that article [4] must be read in the light of G. C. M. 2951, VII–1 Cum. Bull. 160 (1928), which interprets the article and holds (p. 161):

> A corporation whose books of account are on the cash receipts and disbursements basis can only ascertain its earnings and profits by treating as gross income all items of income when received and deducting items of expense when paid.

The Bureau of Internal Revenue has adhered to this view. See I. T. 3253, 1939–1 Cum. Bull. 178; T. D. 5059, 1941–2 Cum. Bull. 125.

Thus it can be categorically stated that the decision of the Board was contrary to the practice of the Bureau, while the decision of the Circuit Court of

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[4] The particular provision which petitioners quote has never appeared in any subsequent regulations.

Appeals is in accord with the Bureau practice. The fact, if it be a fact, that in prior years the Commissioner may have permitted stockholders of the corporation to account for the distributions which they received on the basis for which petitioners argue is quite immaterial.[5]

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted.

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OCTOBER 1943.

[5] The United States is not bound by the mistakes of its agents (*Utah Power & Light Co.* v. *United States*, 243 U. S. 389, 408–409) and no estoppel arises out of the Commissioner having accepted incorrect returns for prior years (*Detroit & Windsor Ferry Co.* v. *Woodworth*, 115 F. 2d 795, 798 (C. C. A. 6th), certiorari denied, 312 U. S. 692; *J. C. Nichols Land Co.* v. *Commissioner*, 65 F. 2d 437, 438 (C. C. A. 8th)).